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SUBJECT: SLOVAKS COMMITTED TO EURO ADOPTION IF EU WILL HAVE THEM

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¶1. (U) Summary - With the steadfast backing of Prime Minister Fico, Slovakia is now meeting the Maastricht economic criteria with the goal of adopting the Euro in January 2009. The concern now turns to the sustainability of the criteria, both in advance of the EU decision and after 2009. The strong appreciation of the Slovak Koruna has led to doubts about the medium-term inflation outlook, while the recent recalculation of the 2006 budget has raised questions about the fiscal targets. The biggest worry, however, is that Slovakia could be held back due to political factors outside of the government's control such as the potential impact of future Euro-zone applications by larger Central European countries. The Central Bank Governor remains confident that Slovakia will soon be a part of the Euro-zone, sentiments that are supported by a strong majority of economic analysts and respected credit rating agencies. End Summary.

NUMBERS LOOK GOOD, BUT ARE THEY SUSTAINABLE?

¶2. (U) Slovakia has been on track to meet the Maastricht criteria since entering the European Exchange Rate Mechanism II (ERM-2) in November, 2005, but officially met all of the fiscal criteria for the first time when the country posted an inflation rate of 2.4 percent in August. Public debt and long-term interest rates have been well within their targets for some time, and the budget deficit for 2007 is forecast at 2.9 percent, just below the 3 percent cutoff. After a strong appreciation of the currency, the central parity was revalued by 8.5 percent in March to 35.4442 SKK/EUR and is currently trading at 33.3 SKK/EUR (Reftel A).

¶3. (U) The biggest concern is whether these benchmarks are sustainable, both through the remaining period of ERM-2 and after January 1, 2009, when Slovakia is scheduled to join the Euro-zone. The European Central Bank (ECB) questioned the sustainability of inflation in an internal memo in June, arguing that the significant drop in inflation was caused by a combination of the strong appreciation of the Slovak Koruna and government efforts to hold down energy prices. The fear is that once Euro-zone entry eliminates currency as an inflation-control tool, price growth will take off again. Analysts regularly point to Lithuania, which was denied entry because its inflation was 0.06 above the threshold, as a cautionary tale for Slovakia. Increasing energy prices are also a concern since the energy-intensive Slovak economy is more sensitive to price changes than other EU countries, and also more dependent on Russian energy supplies than current Euro-zone members.

¶4. (U) Eurostat's October 22 recalculation of the Slovak budget deficit for 2006, raising it 0.3 percentage points to 3.69 percent of GDP, has also raised concerns that the 2007 end-year numbers could go above the 3 percent threshold. Eurostat determined that Slovakia needed to include debts of the public service media and other public finance items. What is not yet clear is whether Eurostat will require Slovakia to include debts from the National Highway Company in the deficit, which some estimate as high as 0.2 percent of GDP. The Ministry of Finance is on record as saying the final deficit for 2007 will be 2.9 percent, though it may require some number shifting - such as paying out Prime Minister Fico's promised Christmas bonuses in January 2008 instead of December 2007. In an October 29 meeting with Ambassador, the Governor of the National Bank of Slovakia (NBS) said that the government will meet the deficit criteria whether or not the highway costs are included in the calculation.

FICO'S SUPPORT UNWAVERING

¶5. (SBU) After overcoming some initial doubts in the first weeks following his election victory in June 2006 about becoming the first Central European country to join the Euro-zone, Prime Minister Fico has been a strong and consistent supporter of Euro-adoption. He has reduced the scope and extended the implementation period of his social reform agenda to ensure that his government would meet the deficit criteria. He certainly has been helped by a booming economy that has provided increased tax revenues to help fund some of these initiatives, but he has also set an ambitious deficit target of 2.4 percent of GDP in the budget proposal submitted to Parliament. Smer MP and Chair of the Foreign Affairs Committee in Parliament Boris Zala told Ambassador that Fico was unwilling to consider early elections despite

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recent coalition turmoil (Reftel B) because he wanted to pass a budget that would meet the Euro criteria. Central Bank Governor Sramko, who played a significant role in changing Fico's opinion about the Euro shortly after the 2006 election, noted to Ambassador that Fico had become a true believer who now viewed Euro adoption as an important part of his legacy. Finance Minister Jan Pociatek jokes that the PM now supports Euro adoption more strongly than he does.

BUT ARE SOLID NUMBERS AND GOVERNMENT SUPPORT ENOUGH?

¶6. (U) There has been widespread speculation in recent weeks that meeting the nominal fiscal criteria may not be enough, and that Slovakia could have its entry into the Euro-zone delayed for what are seen as "political" reasons. Eurostat's recalculation of the budget deficit to include additional expenses was seen as an initial sign by many in Slovakia that playing by the rules may not be enough. Comments in early October by two European Central Bank board members that economic growth in the new EU member states has been a result of the transition and is not "a renewable source of convergence for the future - when the transition is over" were seen as directed at Slovakia since none of the other new EU members are expected to adopt the Euro before 2012. Economic analysts recognize that Slovakia -- more so than Slovenia or even Lithuania -- because of its size and the make-up of its economy, will set the standard for other Euro candidates. The so-called sustainability criteria, which cannot be readily defined as the Maastricht targets and are thus considered "political," are expected to play a factor in the final decision.

¶7. (U) Fico has made several public comments against additional criteria being applied, noting recently that "some new political rules, which were not present before, are beginning to emerge." He has also reportedly raised the issue with several EU heads of state, including France's Nicolas Sarkozy during their early October meeting. The Central Bank Governor told Ambassador that Fico is concerned

that some members of the European Socialist Party (PES), which has suspended membership of Fico's Smer party in the grouping because its coalition partners are viewed as "unacceptable," could use the decision on Euro adoption to make a political point. Sramko does not believe this will happen, and said he has been assured by his EU counterparts that the decision will be based solely on economic criteria.

ANALYST REMAIN BULLISH

¶18. (U) Slovak economic analysts for the most part remain confident that Slovakia will adopt the Euro in 2009. A September survey by the local economic think tank, INEKO, indicated that the level of confidence among economic analysts about Euro adoption was 70 percent, down from 77 percent, but still more than twice the level following the 2006 elections. Both Fitch and Standard and Poors maintain positive assessments of Slovakia's chances, noting that inflation continues to provide the greatest risk.

COMMENT

¶19. (SBU) Much to the surprise of most local political and economic observers, Fico has become one of the strongest advocates for Euro adoption. At the very least, he seems to want to avoid giving the opposition ammunition to attack him for reversing Slovakia's economic progress. Given the subjective nature of judging the sustainability of the macroeconomic criteria, there nevertheless is still a possibility, though widely seen as relatively low, that the EU will delay Slovakia's entry to the Euro-zone. By meeting the Maastricht criteria and leading the drive for adoption in 2009, Fico has positioned himself well for either outcome. He will either be known as the father of Euro adoption, or the victim of a wider conspiracy to keep Slovakia out - both of which could help him in the 2010 elections. A postponement beyond 2009 likely would lead to higher government spending by Fico to more rapidly institute his policy objectives in advance of expected 2010 elections, which would mean that Euro-zone adoption could slip by several years. End Comment.

VALLEE